

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Interpretation of IRC § 3406(c) and IRM 5.19.3.4.2.7 Backup Withholding Provisions

This Chief Counsel Advice responds to your request for assistance dated July 2, 2009.
This advice may not be used or cited as precedent.

ISSUES

1. Do the backup withholding provisions in IRC § 3406(c) and IRM 5.19.3.2.7 contradict each other?
2. Is the IRS always required to stop backup withholding within 45 days after determining that one of the conditions listed in IRC § 3406(c)(3) has been satisfied?

CONCLUSIONS

1. The backup withholding provisions in IRC § 3406(c) and IRM 5.19.3.2.7 do not contradict each other. The IRC provides the deadline by which the IRS has to take action to stop the withholding from occurring, while the IRM provides the deadline by which withholding is normally discontinued.
2. No. The IRS is not required to stop backup withholding within 45 days after determining that one of the conditions listed in IRC § 3406(c)(3) has been satisfied. The 45 days is the number of days the IRS has to take action to stop the withholding from occurring in situations where there was no payee

underreporting or there is a hardship caused (or soon to be caused) by the withholding.

BACKGROUND

IRC § 3406 requires a payor to withhold income tax from reportable payments to recipients if:

- A. The payee fails to furnish a taxpayer identifying number (TIN) to the payor in the manner required;
- B. The Secretary notifies the payor that the TIN furnished by the payee is incorrect;
- C. There has been a notified payee underreporting, described in IRC § 3406(c); or
- D. There has been a payee certification failure, described in IRC § 3406(d).

The tax is withheld at a rate of 28 percent. IRC §§ 1(c); 3406(a). A “reportable payment” is defined as any reportable interest or dividend payment, and any other reportable payment. IRC § 3406(b)(1). The term “other reportable payment” is defined as any payment of a kind, and to a payee, required to be shown on a return required under the following sections of the Internal Revenue Code: 6041, 6041A(a), 6045, 6050A, 6050N, or 6050W. IRC § 3406(b)(3). A payor of a reportable payment is defined as a person required to file a return for that reportable payment. IRC § 3406(h)(4).

The IRS is required to take action to stop backup withholding if it determines that:

- (i) there was no payee underreporting,
- (ii) any payee underreporting has been corrected (and any tax, penalty, or interest with respect to the payee underreporting has been paid),
- (iii) withholding under subsection (a)(1)(C) has caused (or would cause) undue hardship to the payee and it is unlikely that any payee underreporting by such payee will occur again, or
- (iv) there is a bona fide dispute as to whether there has been any payee underreporting.

IRC § 3406(c)(3)(A). See *also* Treas. Reg. § 31.3406(c)-1.

IRM 5.19.3 provides detailed guidance for the Backup Withholding Program, and explains that the IRS has two separate Backup Withholding Programs – the “B” program, which deals with payors who file information returns with incorrect or missing TINs – and the “C” program, which deals with payees who have underreported their interest or dividend income, or failed to file a tax return reporting the income. See IRM 5.19.3.2(1) and (2). The IRS sends a “C” notice to a taxpayer/payee who has underreported a reportable payment or who has failed to pay the tax, penalty, and interest on the reportable payment. See, e.g., CP 539, Backup Withholding Notification.

This memorandum specifically addresses when and how the IRS must take action to stop backup withholding in situations where the IRS has required withholding because a payee has been notified of underreporting (IRC § 3406(c)).

LAW AND ANALYSIS

Issue 1

Before analyzing whether IRC § 3406(c) and IRM 5.19.3.2.7 are consistent with each other, it is important to note that each provision addresses different steps of the backup withholding process -- when and how the IRS must take action in order to stop backup withholding, and the timeline for the actual ceasing of the withholding by the payor.

IRC § 3406(c)(3)(B)(ii) states that if there has been a notified payee underreporting and the IRS later determines that one of the conditions listed in IRC § 3406(c)(3)(A) has been satisfied, the IRS shall “take action” by:

(I) providing the payee with a written certification that withholding under subsection (a)(1)(C) is to stop, and

(II) notify the applicable payors (and brokers) that such withholding is to stop.

In other words, when the IRS “takes action”, as described in IRC § 3406(c)(3)(B), it does not mean that backup withholding will automatically stop. Rather, it means that the IRS will begin the process necessary to stop withholding. Thus, if the IRS has previously given notice to the payor of underreporting, the payor is required to withhold until the IRS notifies the payee and the payor that the withholding is no longer required. See Letter 2027-C, which the IRS sends to the payor when backup withholding is no longer required.

IRC § 3406(c)(3)(C) explains how long the IRS has before it must “take action” to stop backup withholding after it discovers that one of the conditions listed in IRC § 3406(c)(3)(A) has been satisfied. In general, if the IRS has given notice to a payor with respect to any underreporting and then determines by October 15 of any calendar year that the withholding should stop because one of the conditions listed in IRC § 3406(c)(3)(A) has been satisfied, the IRS must take action “to bring about the stopping

of withholding no later than December 1 of such calendar year.” IRC § 3406(c)(3)(C)(i). In situations where the IRS determines there was no payee underreporting, or the withholding has caused (or will cause) undue hardship to the payee, the IRS must take action “no later than the 45th day after the day on which the Secretary made the determination.” IRC § 3406(c)(3)(C)(ii). Thus, nothing in IRC § 3406(c)(3)(C) states how long the withholding will remain in effect after the IRS determines that the condition causing the withholding has been resolved; the only timeframe prescribed is the one in which the IRS has to start the process of stopping the withholding.

In contrast to the obligations of the IRS under IRC §§ 3406(c)(3)(B) and (C), IRM 5.19.3.4.2.7 states the timeline for payors as to how long backup withholding should remain in effect after the IRS determines and notifies the payors that the condition causing the withholding has been resolved. IRM 5.19.3.4.2.7 states that:

Once “C” BWH is imposed, it normally will remain in effect until January 1 of the following year if the condition causing “C” BWH is resolved by October 15. Martinsburg Computing Center will analyze for satisfied modules after October 15th of each year. Any taxpayer subject to “C” BWH who has not resolved the condition by October 15th will continue under “C” BWH the following year.

This IRM provision merely gives a general restatement of the law under IRC § 3406(e)(3). That section provides the specific start and stop dates for determining the period that backup withholding should be in effect in the case of notified payee underreporting.

The payor of the reportable payment is responsible for paying the backup withholding tax while “C BWH” remains in effect. If the condition causing the withholding tax is resolved by October 15 and the payor is properly notified by the IRS, under IRC §§ 3406(e)(3)(B) and (C), the tax will normally remain in effect until January 1st of the following year.

To summarize, IRC § 3406(c) and IRM 5.19.3.4.2.7 are not contradictory. IRC § 3406(c) explains how long the IRS has to take action to stop backup withholding after it determines that one of the conditions listed in IRC § 3406(c)(3)(B) has been satisfied, whereas IRM 5.19.3.4.2.7 states how long backup withholding will remain in effect under IRC § 3406(e)(3) after the condition causing withholding is resolved. The IRS is capable of taking action by December 1 without preventing the January 1st deadline in IRM 5.19.3.4.2.7 and IRC § 3406(e)(3) from being met by the payor (*i.e.*, if by December 1st, the IRS begins the process of stopping the withholding, generally the withholding will cease on January 1st).

Issue 2

The IRS is not always required to stop backup withholding within 45 days after determining that one of the conditions listed in IRC § 3406(c)(3) has been satisfied. In

fact, the IRS is not required to “stop” backup withholding within 45 days after determining that one of the conditions listed in IRC § 3406(c)(3) exists under any circumstances. The IRS is only required to “take action”, as described in IRC § 3406(c)(3)(B)(ii), to stop backup withholding within 45 days in two different situations. Those situations are described in IRC § 3406(c)(3)(C)(ii).

IRC § 3406(c)(3)(C)(ii) explains that if during the 12-month period ending on October 15 of any calendar year, the IRS determines that (1) there was no payee underreporting or (2) withholding has caused (or would cause) undue hardship to the payee and it is unlikely that any payee underreporting by such payee will occur again, the IRS is required to “take action” to stop backup withholding no later than 45 days after making the determination. The 45 days is the number of days the IRS has to take action to stop the withholding from occurring in situations where there was no payee underreporting or there is a hardship caused (or soon to be caused) by the withholding.

There are two additional situations in which the IRS must take action to stop backup withholding. According to IRC § 3406(c)(3)(A), if the IRS determines that (1) a payee underreporting has been corrected (and any tax, penalty, or interest with respect to the payee underreporting has been paid) or (2) there is a bona fide dispute as to whether there has been a payee underreporting, the IRS has until December 1st in the year in which the determination was made to take action to stop backup withholding. There is no 45-day timeframe referenced for these two situations.

In providing this advice, we coordinated with the IRC § 3406 experts in the Office of Chief Counsel, CC:PA:B01.

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Please call _____ if you have any further questions.